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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER, Chairman  
WILLIAM A. MUNDELL  
MARC SPITZER  
MIKE GLEASON  
KRISTIN K. MAYES

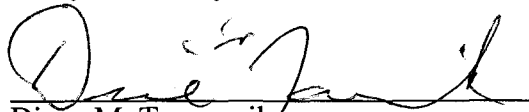
IN THE MATTER OF THE APPLICATION OF  
ARIZONA-AMERICAN WATER COMPANY,  
INC., AN ARIZONA CORPORATION, TO  
EXAMINE POSSIBLE FORMS OF  
MITIGATION OF THE ACRM FOR HAVASU  
WATER DISTRICT.

DOCKET NO. W-01303A-05-0890

**STAFF'S NOTICE OF FILING  
OF DIRECT TESTIMONY**

The Utilities Division ("Staff") hereby provides notice of filing of the Direct Testimony of  
Staff Witness Crystal W. Brown.

RESPECTFULLY SUBMITTED this 23<sup>rd</sup> day of January 2006.

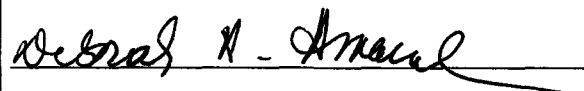
  
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Copy of the foregoing mailed this  
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**BEFORE THE ARIZONA CORPORATION COMMISSION**

JEFF HATCH-MILLER

Chairman

WILLIAM A. MUNDELL

Commissioner

MARC SPITZER

Commissioner

MIKE GLEASON

Commissioner

KRISTIN K. MAYES

Commissioner

IN THE MATTER OF THE APPLICATION OF )  
ARIZONA-AMERICAN WATER COMPANY, )  
INC., AN ARIZONA CORPORATION, TO )  
EXAMINE POSSIBLE FORMS OF MITIGATION )  
OF THE ACRM FOR ITS HAVASU WATER )  
DISTRICT. )  
\_\_\_\_\_ )

DOCKET NO. W-01303A-05-0890

DIRECT

TESTIMONY

OF

CRYSTAL S. BROWN

PUBLIC UTILITIES ANALYST V

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

JANUARY 23, 2006

## **TABLE OF CONTENTS**

	<u>Page</u>
Introduction.....	1
Background .....	2
Consumer Service .....	4
Overview of Original ACRM Authorized In Decision No. 68310.....	4
Step One and Step Two Filings Authorized In Decision No. 68310.....	6
Company Proposed Changes To The Authorized Step Two ACRM Filing.....	7
Staff Recommended Modifications to The Company's Step Two Filing Proposal.....	8
Recognition of accumulated amortization of CIAC related to arsenic treatment plant in the arsenic rate base calculation.....	11
Recognition of accumulated deferred income taxes related to arsenic treatment plant in the arsenic rate base calculation.....	11
Benefits of Company's Revised Step Two Proposal .....	12
Arsenic impact Fee .....	12
Summary of Recommendations.....	13

## **Attachment**

Memorandum from Marlin Scott, Jr., Utilities Engineer

**EXECUTIVE SUMMARY**  
**ARIZONA-AMERICAN WATER COMPANY**  
**DOCKET NO. W-01303A-05-0890**

Arizona-American Water Company, Inc. ("Arizona-American" or "Company") provides potable water, irrigation water, and wastewater services to approximately 115,000 customers in Arizona.

On April 15, 2005, Arizona-American filed an application for authority to implement Arsenic Cost Recovery Mechanisms ("ACRM") for its Agua Fria, Sun City West, Havasu, and Tubac Water Districts. On May 4, 2005, Arizona-American filed a motion to delete Tubac Water District from its application.

On May 31, 2005, Arizona-American filed its request for an Arsenic Impact Fee Tariff for the Havasu Water District.

On November 14, 2005, the Arizona Corporation Commission ("Commission"), in Decision No. 68310, along with other items, authorized an ACRM for customers in the Havasu Water District and directed Utilities Division ("Staff") and the Company to "examine other forms of mitigation of the ACRM for the Havasu system, including the use of hook-up fees for adjacent systems."<sup>1</sup>

On December 13, 2005, Arizona-American, filed a new application to examine possible forms of mitigation of the ACRM and present its findings and proposals to the Commission.

Staff recommends approval of the Company's proposed revision to its authorized ACRM Step Two filing subject to the following modifications:

1. The start date of the Allowance for Funds Used During Construction ("AFUDC") accrual begin at the effective date of the Step Two filing.
2. Accumulated amortization of CIAC related to arsenic treatment plant is recognized in the arsenic rate base calculation.
3. Accumulated deferred income taxes related to arsenic treatment plant is recognized in the arsenic rate base calculation.

Further, Staff recommends that an arsenic impact fee in the Mohave system for the benefit of Havasu customers not be adopted.

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<sup>1</sup> Decision No. 68310, dated November 14, 2005, page 17, beginning at line 1.

1 **INTRODUCTION**

2 **Q. Please state your name, occupation, and business address.**

3 A. My name is Crystal S. Brown. I am a Public Utilities Analyst V employed by the Arizona  
4 Corporation Commission ("ACC" or "Commission") in the Utilities Division ("Staff").  
5 My business address is 1200 West Washington Street, Phoenix, Arizona 85007.  
6

7 **Q. Briefly describe your responsibilities as a Public Utilities Analyst V.**

8 A. I am responsible for the examination and verification of financial and statistical  
9 information included in utility rate applications. In addition, I develop revenue  
10 requirements, prepare written reports, testimonies, and schedules that include Staff  
11 recommendations to the Commission. I am also responsible for testifying at formal  
12 hearings on these matters.  
13

14 **Q. Please describe your educational background and professional experience.**

15 A. I received a Bachelor of Science Degree in Business Administration from the University  
16 of Arizona and a Bachelor of Science Degree in Accounting from Arizona State  
17 University.  
18

19 Since joining the Commission, I have participated in numerous rate cases and other  
20 regulatory proceedings involving electric, gas, telecommunications, and water utilities. I  
21 have testified on matters involving regulatory accounting and auditing. During the past  
22 nine years, I have attended utility-related seminars on regulation, accounting, finance and  
23 income taxes that provide continuing and updated education in these areas. Various  
24 professional and industry organizations sponsored these seminars.  
25

1 I have been employed by the Commission as a regulatory auditor and a rate analyst since  
2 August 1996. Prior to joining the Commission, I was employed by the Department of  
3 Revenue as a Senior Internal Auditor and by the Office of the Auditor General as a  
4 Financial Auditor. I was a Cost Center Review Specialist for Blue Cross Blue Shield of  
5 Arizona prior to my employment in state government.

6  
7 **Q. What is the purpose of Staff's testimony?**

8 A. The purpose of Staff's testimony is to discuss Staff's recommendations to Arizona-  
9 American Water Company's ("Arizona-American" or "Company") two proposals  
10 concerning the recovery of arsenic treatment costs for its Havasu water district. The  
11 proposals were filed in response to the Commission's direction to "examine other forms of  
12 mitigation of the ACRM ["Arsenic Cost Recovery Mechanism"] for the Havasu system,  
13 including the use of hook-up fees for adjacent systems."<sup>2</sup>

14  
15 Staff witness Marlin Scott, Jr., is also presenting Staff's engineering analysis and  
16 recommendations regarding the Company's Arsenic Impact Fee proposal for the Havasu  
17 water district in the attached memorandum.

18  
19 **BACKGROUND**

20 **Q. Please review the background of this application.**

21 A. Arizona-American Water Company, Inc. provides potable water, irrigation water, and  
22 wastewater services to approximately 115,000 customers in Arizona.

23  
24 On November 22 and December 13, 2002, Arizona-American Water Company, Inc. filed  
25 applications for fair value determinations of its utility plant and for permanent rate

---

<sup>2</sup> Decision No. 68310, dated November 14, 2005, page 17, beginning at line 1.

1 increases for five of its districts. On June 30, 2005, the Commission issued Decision No.  
2 67093 that established fair values and authorized permanent rate increases for the five  
3 districts.

4  
5 On December 17, 2004, Arizona-American filed a motion to request that the Commission  
6 re-open the record in Decision No. 67093. The purpose of the motion was to provide an  
7 evidentiary basis that would allow the Commission to consider modifying the order so that  
8 an ACRM could be added. Decision No. 67593, dated February 15, 2005, authorized the  
9 re-opening of the rate case order "solely for adding an Arsenic Recovery Mechanism."

10  
11 On March 29, 2005, Arizona-American was directed by procedural order to file a new  
12 application requesting an ACRM. The new application was to include all dockets from  
13 Decision No. 67093 that would be affected by the ACRM request. On April 15, 2005,  
14 Arizona-American filed an application for authority to implement ACRM's for its Agua  
15 Fria, Sun City West, Havasu Water, and Tubac Water Districts. Additionally, the  
16 Company requested a hook-up fee for its Havasu and Tubac Water Districts. On May 4,  
17 2005, Arizona-American filed a motion to delete Tubac Water District from its  
18 application.

19  
20 On May 31, 2005, Arizona-American filed its request for an Arsenic Impact Fee Tariff for  
21 the Havasu water district. On June 8, 2005, Arizona-American filed revised direct  
22 testimony for Company witness, Thomas M. Broderick.

23  
24 On November 14, 2005, the Commission, in Decision No. 68310, along with other items,  
25 authorized an ACRM for customers in the Havasu Water District and directed Staff and

1 the Company to “examine other forms of mitigation of the ACRM for the Havasu system,  
2 including the use of hook-up fees for adjacent systems.”<sup>3</sup>  
3

4 On December 13, 2005, Arizona-American, filed a new application to examine possible  
5 forms of mitigation of the ACRM and present its findings and proposals to the  
6 Commission.  
7

#### 8 **CONSUMER SERVICE**

9 **Q. Please provide a brief history of customer complaints received by the Commission**  
10 **regarding Arizona-American’s filing.**

11 A. There has been only one opinion filed against Arizona-American Water Company’s  
12 Havasu Water District regarding the arsenic charge. Other filings during the past three  
13 years consist of three complaints, five inquiries and one opinion registered against the  
14 Havasu Water District. None of these were regarding the arsenic charge. All complaints  
15 and inquiries filed against the company’s Havasu Water District have been resolved and  
16 closed.  
17

#### 18 **OVERVIEW OF ORIGINAL ACRM AUTHORIZED IN DECISION NO. 68310**

19 **Q. Please provide a brief overview of the current ACRM authorized in Decision No.**  
20 **68310, dated November 14, 2005.**

21 A. The ACRM overview is as follows:

- 22 1. The ACRM is to be based on actual costs. The costs eligible for recovery are  
23 depreciation expense, return, and recoverable operations and maintenance expense  
24 (“O&M”).  
25

---

<sup>3</sup> Decision No. 68310, dated November 14, 2005, page 17, beginning at line 1.



- 1           2.     Rate recovery for the ACRM begins after new facilities are in service and are in  
2                 compliance with the new USEPA<sup>4</sup> arsenic standard, which goes into effect January  
3                 23, 2006.
- 4
- 5           3.     Arizona-American will file rate applications for a permanent rate increase case for  
6                 the Agua Fria, Havasu, and Sun City West water districts no later than April 30,  
7                 2008, using 2007 as the test year.
- 8
- 9           4.     The ACRM rate design will generate 50 percent of the costs from the monthly  
10                customer charge and 50 percent from the commodity charge.
- 11
- 12          5.     Ten schedules as required in Decision No. 66400 will be filed with each ACRM  
13                request.
- 14
- 15          6.     Recoverable operations and maintenance costs include only media replacement or  
16                regeneration, media replacement or regeneration service, and waste disposal.
- 17
- 18          7.     A deferral for future recovery of up to 12 months of recoverable O&M without  
19                return commencing with the in-service of facility(s) within each district.
- 20
- 21          8.     Two-step rate increases in each district with an ACRM.
- 22
- 23          9.     No true-up of the ACRM for over- or under-collection.
- 24

---

4.

1           10.     Return included in the ACRM based upon earlier return of and return on equity  
2                     findings which, for Arizona-American, was 9 percent authorized in Decision No.  
3                     67093, dated June 30, 2004.  
4

5     **STEP ONE AND STEP TWO FILINGS AUTHORIZED IN DECISION NO. 68310**

6     **Q.     What costs in the current Step One ACRM filing would be recoverable through a**  
7             **surcharge or deferred and recovered at later date?**

8     A.     The costs authorized for recovery through a surcharge under the Step One ACRM filing  
9             are depreciation expense and return on arsenic treatment plant (i.e., capital costs). The  
10            plant must be in service and providing water that meets EPA drinking water standards. In  
11            addition, media replacement or regeneration, media replacement or regeneration service,  
12            and waste disposal O&M expenses incurred during the first year of operation<sup>5</sup> are  
13            authorized for deferral and recovery at a later date (i.e., during the Step Two filing). The  
14            Step One filing would be filed no earlier than January 24, 2006.  
15

16    **Q.     What costs may be recovered in the currently authorized Step Two ACRM**  
17            **surcharge?**

18    A.     The costs that may be recovered in the currently authorized Step Two ACRM surcharge  
19            are (1) O&M expenses incurred and deferred under Step One during the first year of  
20            arsenic treatment plant operation and (2) on-going O&M expenses of the arsenic treatment  
21            plant. The Step Two filing would be filed no earlier than January 24, 2007.<sup>6</sup>  
22

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<sup>5</sup> Decision No 68310 at page 8, beginning at line 4.

<sup>6</sup> Id., beginning at line 12.

**COMPANY PROPOSED CHANGES TO THE AUTHORIZED STEP TWO ACRM FILING**

**Q. What changes does the Company propose to the currently authorized Step Two ACRM?**

A. The Company proposes to capitalize the O&M expenses deferred in Step One and amortize the capitalized amount over the remaining life of the arsenic treatment plant instead of recovering them in one year through the ACRM surcharge. The Company also proposes to accrue and capitalize an Allowance for Funds Used During Construction ("AFUDC") on the capitalized amount.

**Q. Please discuss the details of the Company's proposal?**

A. According to the Company's application, the details are as follows:

1. Twelve months of eligible media expenses during the initial commercial operation in Havasu would be permanently capitalized, as incurred, into the Havasu arsenic facility;
2. Subsequent depreciation of the capitalized media expenses would not commence until the effective date of new permanent rates in Havasu that include the capitalized media expense in rate base;
3. AFUDC will accrue on the capitalized media expenses from the date(s) capitalized until the effective date of new permanent rates in Havasu that include the capitalized media expense in rate base;
4. The mitigated Step Two ACRM increase in Havasu would then contain only 12 months of ACRM eligible media expense, not 24 months as otherwise provided for

1 in Step 2 of the ACRM. As a result, there would be no deferred O&M to remove  
2 from the ACRM surcharge 12 months after implementation of the Step Two  
3 ACRM surcharge increase as provided for in the administration of the ACRM in  
4 our other districts;

5  
6 5. At the time of Arizona-American's Step Two ACRM filing for the Havasu Water  
7 District, the Company would provide the Commission with accounting data  
8 sufficient for review of the reasonableness of the 12 months of actual media  
9 expenses incurred as already provided for in the administration of the approved  
10 ACRM;

11  
12 6. An accounting order will be necessary to allow Arizona-American to capitalize the  
13 first 12 months of actual media expense. The order will have to assure recovery of  
14 the capitalized media expense, provided that the Company has satisfied the  
15 Commission of the reasonableness of the expense, as provided in paragraph 5  
16 above. This will allow Arizona-American's accountants and auditors to establish  
17 the deferrals under generally accepted accounting principles ("GAAP") without  
18 offsetting reserves.

19  
20 **STAFF RECOMMENDED MODIFICATIONS TO THE COMPANY'S STEP TWO**  
21 **FILING PROPOSAL**

22 **Q. Is Staff in substantial agreement with the Company's proposed revision?**

23 **A.** Yes, with the exception of three items, Staff is in substantial agreement.  
24

1 **Q. What are Staff's recommended modifications to the Company's Step Two Filing**  
2 **Proposal?**

3 A. Staff recommends the following:

- 4 1. Change the start date of the AFUDC accrual;
- 5
- 6 2. Recognition of accumulated amortization of contributions in aid of construction  
7 ("CIAC") related to arsenic treatment plant in the arsenic rate base calculation.  
8
- 9 3. Recognition of accumulated deferred income taxes related to arsenic treatment  
10 plant in the arsenic rate base calculation.  
11

12 **Change Start Date of AFUDC Accrual**

13 **Q. What is AFUDC?**

14 A. AFUDC is an accounting mechanism that is similar to interest expense. The calculation of  
15 AFUDC is defined by the NARUC USOA<sup>7</sup> and includes interest on borrowed funds and  
16 the cost of equity funds used to finance construction. It is capitalized by adding the  
17 amount to the value of the plant and is amortized over the useful life of the plant.  
18

19 **Q. Is there a provision for AFUDC in the currently authorized Step Two filing?**

20 A. No. AFUDC is not a provision in the currently authorized Step Two filing.  
21

22 **Q. Is the Company's proposal to include AFUDC appropriate?**

23 A. Yes, because it allows the Company to recover the cost it has incurred for financing the  
24 additional delay in recovering the first year O&M costs for the arsenic treatment plant.  
25

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<sup>7</sup> National Association of Regulatory Utility Commissioners ("NARUC") Uniform System of Accounts ("USOA")

1     **Q.     Does Staff have a concern about the start date of the AFUDC accrual?**

2     A.     Yes. Under the currently authorized Step Two filing, the Company could make a filing to  
3     recover the first year's eligible O&M expenses no sooner than January 24, 2007, and  
4     would begin recovery of the actual expense through rates upon approval by the  
5     Commission. However, under the Company's proposed revision to the Step Two filing,  
6     the Company could capitalize the actual expense and begin to recover the carrying cost  
7     (via AFUDC) as soon as the expenses are capitalized, which could happen sooner than  
8     January 24, 2007.

9  
10    **Q.     What is the effect of the Company proposed start date?**

11    A.     If any of the eligible O&M expenses are capitalized prior to January 24, 2007, the total  
12    amount of the O&M expenses to be recovered would be greater under the Company's  
13    revised proposal as compared to the existing authorized ACRM.

14  
15    **Q.     What is Staff recommending?**

16    A.     Staff recommends that the start date of the AFUDC accrual begin on the effective date of  
17    the Commission approved Step Two filing to recover ongoing eligible O&M expenses.  
18    Staff's recommendation has the effect of restoring the recoverable amount of O&M  
19    expenses on a present value basis to the currently authorized ACRM amount.

20

**Recognition of accumulated amortization of CIAC related to arsenic treatment plant in the arsenic rate base calculation**

**Q. What problem did Staff note concerning the rate base calculation on the Company's "Arsenic Compliance Revenue Requirement Schedule"?**

A. The Company's example on the "Arsenic Compliance Revenue Requirement – Havasu" Schedule shows an amortization of CIAC but does not reflect the related amortization<sup>8</sup>. The schedule should reflect the amortization and the accumulated amount.

**Q. What effect did the Company's omission of accumulated amortization of CIAC have on the rate base in its example?**

A. The rate base calculation in the Company's example is understated.

**Q. What is Staff recommending?**

A. Staff recommends that accumulated amortization of CIAC be properly reflected in the calculation of arsenic related rate base.

**Recognition of accumulated deferred income taxes related to arsenic treatment plant in the arsenic rate base calculation**

**Q. Does Staff have a concern about Deferred Income Taxes?**

A. Yes, the Company's example did not include a provision for accumulated deferred income taxes in the calculation of arsenic related rate base.

**Q. What is Staff recommending?**

A. Staff recommends that accumulated deferred income taxes related to the arsenic treatment facilities be reflected in the calculation of arsenic related rate base.

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<sup>8</sup> The line is entitled "Accumulated Amortization on Havasu Impact Fee Contribution – Dec. '05 to Mar. '07".

**Benefits of Company's Revised Step Two Proposal**

**Q. What are the benefits of the Company's revised Step Two proposal?**

A. The Company's revised ACRM proposal results in a lower Step Two surcharge than would result under the currently authorized ACRM and it does not result in one system subsidizing another system.

**ARSENIC IMPACT FEE**

**Q. Please provide a brief overview of the Company's secondary, or alternate, proposal for an Arsenic Impact (hook-up) Fee?**

A. According to the Company's application, the arsenic impact fee would be as follows:

1. Customers in the Mohave Water District would subsidize the customers in the Havasu water district.
2. Mohave impact fees would be treated as ACRM revenue in the Havasu Water District.
3. A balancing account would be used so that over- or under-collections would reduce or increase subsequent impact fees on a true-up basis.
4. The fee would be temporary until the arsenic facilities and costs were reflected in the base rates as the result of the next Havasu Water District rate case.

**Q. What concern does Staff have about the Company's Arsenic Impact Fee alternative?**

A. The impact fee does not follow traditional ratemaking principles of cost causation and cost of service. Ratepayers of the Mohave district would be required to pay the cost of providing service to customers who are in a water system that is about 50 miles away with



1 no identifiable benefit. The arsenic impact fee represents a direct subsidy from Mohave  
2 district customers to Havasu customers.

3  
4 **Q. Does the Company prefer the hook up fee?**

5 A. No, it does not.

6  
7 **Q. What is Staff recommending?**

8 A. Staff recommends that the arsenic impact fee not be adopted.

9  
10 **SUMMARY OF RECOMMENDATIONS**

11 **Q. Please summarize Staff's recommendations.**

12 A. Staff recommends approval of the Company's proposed revision to its authorized ACRM  
13 Step Two filing subject to the following modifications:

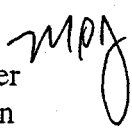
- 14 1. The start date of the AFUDC accrual begin at the effective date of the Step Two  
15 filing;
- 16
- 17 2. Accumulated amortization of CIAC related to arsenic treatment plant is recognized  
18 in the arsenic rate base calculation;
- 19
- 20 3. Accumulated deferred income taxes related to arsenic treatment plant is recognized  
21 in the arsenic rate base calculation; and
- 22
- 23 4. That the arsenic impact fee not be adopted.
- 24

25 **Q. Does this conclude your direct testimony?**

26 A. Yes, it does.

## MEMORANDUM

TO: Crystal Brown  
Public Utilities Analyst V  
Utilities Division

FROM: Marlin Scott, Jr.   
Utilities Engineer  
Utilities Division

DATE: January 5, 2006

RE: ARIZONA AMERICAN WATER COMPANY, INC. – HAVASU WATER  
DISTRICT  
DOCKET NO. W-01303A-05-0890

### **Introduction**

In Decision No. 68310 (November 14, 2005), Arizona American Water Company – Havasu Water District (“Havasu”) was approved for an Arsenic Cost Recovery Mechanism (“ACRM”) and an Arsenic Impact Hook-up Fee (“AIHUF”) Tariff. The AIHUF charges started at \$870 for a 5/8 x 3/4-inch meter and increased for larger meter sizes. In that Decision, a portion of the Order directed Staff and Havasu to examine other forms of mitigation of the ACRM, including the use of hook-up fees for adjacent systems. In its filing, Havasu has offered two proposals to mitigate the impact of the ACRM on the Havasu system.

### **Staff Examination**

#### Havasus’s Proposals

The first proposal, Deferral Proposal, would reduce the amount of the expected Step 2 increase by capitalizing and deferring recovery of eligible operation and maintenance (“O&M”) cost until Havasu’s next rate case. The second proposal, Mohave Arsenic Impact Fee, would implement impact fees in Arizona American’s Mohave Water District to offset much of the Havasu ACRM step increases.

#### Staff’s Comments

Staff Engineering has reviewed the proposed Step-1, Step-2 and Step-3 Mohave “O&M” impact fees of \$264, \$274 and \$456 per new connection, respectively. Each Step fee was calculated based on Mohave Water District’s growth projection and eligible O&M cost for 12 month periods. Staff Engineering considers the proposed Step – Mohave O&M impact fees of \$264, \$274 and \$456 per new connection as some type O&M surcharge and should not be recognized as a hook-up fee.

:msj